Internal Revenue Service

memorandum

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Br2:MANixon

date: NOV 5 1990

to: District Counsel, Hartford CC:HAR
Attn: Joseph Long

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This responds to your August 2, 1990, request for Tax Litigation Advice. The above captioned case is a [redacted] case from the [redacted] District. The amount in controversy is $[redacted]. You recently filed an answer in this case and have forwarded the administrative file to the Boston Appeals Office for consideration.

ISSUE

Whether [redacted], created children's programs featuring its products primarily for use as public entertainment, so as to qualify for the investment tax credit for television films under I.R.C. § 48(k) and Treas. Reg. § 1.48-8(a)(3)(ii).

FACTS

According to your memorandum of August 2, 1990, and supporting materials, the facts are as follows:

[redacted] ([redacted]) is the world's [redacted]. It sells its products nationally and internationally. During the years at issue [redacted], through a licensing agreement with an unrelated third party, produced [redacted] and [redacted], some (if not all) of whose characters were the company's [redacted]. It is unclear which [redacted] and [redacted] actually featured the company's [redacted].

The productions that featured [redacted] products, while obviously providing exposure for the [redacted], were not advertisements in the traditional sense. In other words, they were not 15-, 30-, or 60-second spots shown during commercial breaks from regular programming. Instead, they were full length television shows, designed to have entertainment value in themselves.

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For example, [redacted]'s "[redacted]" [redacted] was the focus of the "[redacted] - [redacted]" series. Likewise, the products "[redacted]" and "[redacted]" were showcased in programs of the same name. The programs were broadcast on TV stations throughout the U.S. You expect [redacted] will show that TV stations paid substantial fees for broadcast rights to the programs.

[redacted] is reluctant to acknowledge the promotional and advertising value of the programs. Nonetheless, the programs provide exposure for [redacted] products directly to consumers, which is a function of advertising. [redacted]'s own promotional materials support this conclusion. The company's [redacted] catalogue informs retailers that "Brand new TV specials are planned for [redacted] in [redacted]! [redacted]! All this means sensational sales for you." (Revenue agent's report, [redacted], p. [redacted]). Another item in the catalogue tells retailers that "starting in September the adventures of [redacted] will be seen as a [redacted] television series. This anticipated afternoon event will encourage more [redacted] 'play adventures' while creating even greater demand at the retail level." (Revenue agent's report, [redacted], p. [redacted]).

[redacted]'s attorney, in his [redacted] letter to IRS attorney Joseph F. Long, implicitly recognized the promotional value of the programs. He acknowledged that they "exploit [redacted] that are also marketed as [redacted] by [redacted]" [redacted]." This statement implies that [redacted] had another motivation in creating the programs, namely, to sell its products.

Thus, it appears from the facts that the programs at issue have at least two uses. First, they are used to entertain an audience. Second, they promote [redacted] by exposing them to that same audience. The question boils down to which use is primary and which is secondary for purposes of determining whether [redacted] is entitled to the investment tax credit.

You have requested our advice because this a case of first impression involving the interpretation of Treas. Reg. § 1.48-8(a)(3)(ii). In your opinion it involves severe litigation hazards.

DISCUSSION

Law

Under section 48(k), an otherwise qualified motion picture film or video tape meets the requirements for the investment tax credit if it was "created primarily for use as public entertainment or for educational purposes."

Treas. Reg. § 1.48-8(a)(3)(i) reiterates this requirement, stating that a "qualified film" (a film eligible for the credit) is a film or video tape "created primarily for use as public entertainment or for educational purposes."

Treas. Reg. § 1.48-8(a)(3)(ii) contains an explanation of the phrase "created primarily for use as public entertainment or for educational purposes." It provides:

> (ii) Public entertainment or educational purposes. A film or tape is created primarily for use as public entertainment only if created principally for public exhibition for the amusement, enlightenment, or gratification of an audience. Thus, a dramatic or situation comedy show or episode or a dramatic or situation comedy series would be a film or tape created primarily for use as public entertainment. A film or tape is created primarily for educational purposes if it is created principally for use by educational institutions or government units such as primary or secondary schools, colleges and universities, vocational and post-secondary educational institutions, public libraries, and other government units. Films and tapes created primarily for use by industrial or commercial organizations do not qualify for the credit. Thus, advertisements and industrial training films and tapes do not qualify for the credit.

Treas. Reg. § 1.48-8(a)(3)(ii). (emphasis added).

The legislative history of section 48(k) provides no further insight on this issue. The Senate report on section 48(k) states that the credit is available for "motion picture or television films or tapes created primarily for use as public entertainment." S. Report 94-938, 1976-3 C.B. (Vol. 3) at 224-225. The House report contains an identical provision. House Report No. 94-658, 1976-3 C.B. (Vol. 2) at 880-881. Neither the Senate report nor the House report contains a reference to advertising.

No cases, revenue rulings, or other authorities directly address this issue.

We agree with the District's position that the [redacted] created by [redacted] are not qualified films because they were created principally for advertising, marketing, and product promotion purposes. Our reasons are set forth below.

Dual Components

The resolution of this issue hinges on a determination of [redacted]'s primary purpose in producing and marketing the programs that showcase [redacted]. The programs have two components. The first component is the promotional one -- the programs expose [redacted] products to consumers and thereby promote them. In this sense they are in the nature of advertising. The second component is entertainment. If the programs were not capable of amusing and holding an audience, TV stations would obviously not broadcast them, much less pay [redacted] for the right to do so.

Treas. Reg. § 1.48-8(a)(3)(ii) states that the credit is allowable only if the programs were "created primarily for use as public entertainment." Thus, the central question is what was [redacted]' primary intent in producing and marketing the programs. Did it produce the programs primarily as advertising, or as entertainment?

Analogous Situation

The issue of dual purpose investment tax credit property has come up before. In GCM 39443, the issue was whether a motorhome qualified for the credit because it was used by the taxpayer to travel to his temporary work assignments.

Section 48(a) denies the credit to property used "predominantly to furnish lodging." However, under Treas. Reg. § 1.48-1(h)(1), lodging property does not include "a facility used primarily as a means of transportation." Thus, the issue

was the primary use of the motorhome. If it was used primarily for lodging, it was not eligible for the credit. If it was used primarily for transportation, it qualified for the credit.

The GCM states that the primary use test of Treas. Reg. § 1.48-1(h)(1) "requires a comparison of uses (transportation and lodging) that cannot be reduced to a specific formula." Based on all the facts and circumstances, it concludes that the taxpayer's use of the motorhome was primarily for lodging. Thus, the credit was denied.

GCM 39443 also considers whether the motorhome should be treated as two separate assets for purposes of the investment tax credit. It concludes that division of the property into two separate assets, one used for transportation and the other for lodging, would require a change in the regulations.

The parallels between GCM 39443 and [redacted] are obvious. The motorhome had two uses, and the cartoons have two uses. One use qualifies for the investment tax credit, the other does not. Treas. Reg. § 1.48-(1)(h)(1) allows the credit for lodging property used "primarily as a means of transportation." Treas. Reg. § 1.48-8(a)(3)(ii) requires that a film be created "primarily" as entertainment to qualify for the credit; if it is primarily an advertisement, it does not qualify.

In GCM 39443, section 48(a) denied the credit to property used "predominantly" as lodging." Because the motorhome was not used "primarily" as transportation, it did not qualify for the exception provided in Treas. Reg. § 1.48-1(h)(1). Under the terms of the statute and the regulations, the motorhome's two uses -- transportation and lodging -- were compared and a factual determination was made as to which was the primary use. Such a factual determination will have to be made in the [redacted] case.

Primary Purpose

Case law abounds with situations in which taxpayers engaged in transactions with more than one purpose. The cases were litigated because the tax consequences of the transactions depended on which purpose was primary. "The instances are many in which purpose or state of mind determines the incidence of an income tax." Helvering v. National Grocery Co., 304 U.S. 282, at 289 (1938).

Many if not most of the cases involve losses claimed under section 165, and the issue is whether the taxpayer engaged in an activity or entered into an activity primarily for profit. In each case, the court looks at all the facts and circumstances and makes a factual determination of the taxpayer's primary purpose.

A frequently cited case involving dual purposes is Austin v Commissioner, 35 T.C. 221 (1960). The issue was whether the taxpayer's purchased a house primarily as a residence or primarily to make a profit. The court, after considering all the facts and circumstances, determined that the taxpayer purchased the property "primarily as a residence and secondarily to make a profit." Austin at 227. Thus, the taxpayer's deduction under section 165 of losses on the sale of the house was denied. In affirming, the Second Circuit upheld the Tax Court's conclusion as a factual finding that was not "clearly erroneous." Austin v. Commissioner, 298 F.2d 583, 584 (2nd Cir. 1962).

Analysis

As in Austin, the resolution of [redacted] should depend on a factual determination of which of the company's two purposes (entertainment or advertising) is primary and which is secondary. To get the credit, [redacted] will have the burden of proving that its primary purpose in creating the programs was to entertain an audience.

Proving that its primary purpose was to entertain an audience could be difficult for [redacted]. Historically, [redacted]'s principal business has been the [redacted] and [redacted] of [redacted]. (Although the company entered the [redacted]'s entertainment business in [redacted], the nature of its entertainment business changed in the early [redacted], when it began production of programs that showcase its products.) Thus, it might have trouble convincing the Tax Court that it did not create the programming at issue with a primary intent to increase [redacted] in its historical business -- the [redacted].

Furthermore, the materials provided by the revenue agent document the position of children's groups that these programs are simply commercials for [redacted]. The position of the children's groups, while certainly not dispositive, is supported by [redacted]'s own catalogue. As noted above, the catalogue tells retailers that the programs will boost sales.

In light of the promotional nature of the programs, it is logical to conclude that [redacted] created the [redacted] primarily to [redacted] its [redacted] and secondarily as entertainment. As a [redacted], profits from the sales of its [redacted] would be its primary motivation. Any profits earned from the creation of [redacted] that enhance sales would be secondary.

There are, of course, litigation hazards associated with this position. [redacted] has a history of involvement in [redacted]'s programming, some of which is clearly not advertising. In

addition, [redacted] will attempt to portray itself as an [redacted] "[redacted]," rather than a [redacted] of [redacted].

Furthermore, courts tend to liberally construe allowances for investment tax credits and have not always been receptive to the Service's position in this regard. For example, Treas. Reg. § 1.48-8(a)(3)(iii) as originally written was struck down in a series of cases. However, we note that the issue in those cases was whether certain programs were "topical or transitory" and thus not worthy of the credit. That portion of the regulations is not at issue here.

CONCLUSION

Based on the above, we believe that the programs were not created with a primary intent to entertain an audience. Instead, the were created primarily as advertising. Thus, [redacted] should not be entitled to the investment tax credit for television films under section 48(k) and Treas. Reg. § 1.48-8(a)(3)(ii).

If you have any questions, or need further information, contact Michael A. Nixon at FTS 566-3407.

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